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FEDERAL INCOME TAX REFORM AND RENTAL HOUSING DEVELOPMENT IN BOSTON

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Abstract

Congress has redesigned the tax laws reducing the preferential tax treatment given to income earning real estate. This particularly hurts multi-family rental housing. Analysis of operating statements of typical rental properties indicates that new developments under tax reform, will have to locate in markets with significantly higher rents in order to earn the same rate of return on investment achieved before tax reform. Tax reform offers some incentives for setting aside a percentage of units for occupancy by low- and moderate-income households. Estimation of the value of these tax benefits suggests that these incentives do not fully compensate for the costs of setting aside these units. Developers will not, voluntarily, set aside units for low- and moderate-income households. Added incentives or requirements will be necessary in order to induce developers to make use of these provisions of the the tax code.

Introduction.

The City of Boston, as a matter of public policy, is concerned with the number of additions to its housing stock. At present the stock suffers a very low vacancy rate, estimated to be about 4 percent which is very low for a city such as Boston which experiences a annual turnover rate in its rental stock in excess of 30 percent. This scarcity is a problem for all Boston renter households when they seek housing but is a particular problem for low- and moderate-income renters who are unable to compete for the units offered at relatively high rents. Without an adequate supply of moderately priced rental housing units, these households are forced to pay an excessively high percentage of their income in order to house themselves.

Boston is primarily a city of renters with about two-thirds of its housing units being in rental tenure and about one-third owner-occupied units. Boston is also primarily a city of multi-family structures with over one-half of the housing units in the City being in buildings containing three or more units and only about 12 percent of all housing units in single-family detached structures. Among renters, less than 4 percent of their units are in single-family attached or detached buildings. All other rental units are in multi-family structures of various sizes.

Given this configuration of the housing stock, the level of new investment in multi-family units is crucial to the growth and continued renovation of the city's housing. This report addresses the changes in the federal income tax code with regard to investment in real estate with special attention to their effects upon incentives to invest in rental housing. The impact of tax reform upon owner-occupied housing is not addressed here because of the city's dependence upon rental housing and also because tax reform will largely leave unchanged the tax benefits granted to owner-occupants. Home owners will continue to be allowed to deduct the local property taxes and interest payments on loans taken for the purchase of a home. Changes in tax rates will effect the value of these deductions for home owners, but the tax reform provisions will have their greatest impact on rental housing.

The Importance of the Tax Code to Multi-Family Rental Properties.

For the past several years, real estate has enjoyed preferential treatment in terms of taxation of income derived from investment in that sector of the economy. This preferential treatment was designed to encourage investment in real estate by making it a better alternative for investment than it would be without the benefits of the tax treatment. It has been public policy to encourage such investment, particularly in housing, so that the supply of capital to the housing sector would be sufficient to generate an adequate number of housing units to meet the population's needs.

This preferential treatment has taken four forms; accelerated depreciation allowances, the ability to use deductions generated by a piece of real estate to shelter income from other sources, partial exclusion of capital gains income from taxation and tax credits for the rehabilitation of historic buildings.

Accelerated depreciation. Prior to tax reform, income from investment in real estate could avoid taxation in that the income could be made into a loss for tax purposes through the deduction of accelerated depreciation. Losses are generated by permitting deductions to be made from income as a function of the assumed depreciation of the property even though the rate of actual depreciation of the building and

other improvements to the property may be very low. For example, a building may have a useful life of 50 years from the time that it was new and the depreciation of the building over that 50 years may be more or less linear with 1/50 of its useful life being lost each year. For tax purposes, however, it has been possible to assume that a building depreciates over as short a period as 15 to 19 years and with the depreciation being greater in the early years of its operation. Given this assumption that depreciation occurs more rapidly in the early years, the tax codes have permitted depreciation deductions to be made at levels as much as double the normal straight line amount calculated by dividing the non-land value of the property by its depreciable life. In addition, each time a property is sold, the new owner may begin the depreciation cycle anew, taking advantage of the depreciation deductions, independent of the prior owners deductions or the age of the building.

Use of real estate losses to shelter non-real estate income. The provisions for a short depreciable life of a building and for more rapid depreciation in the early years are referred to as the process of accelerated depreciation. This accelerated depreciation accounting procedure has value to investors in that a piece of real estate often produces losses far in excess of its taxable income, at least in the first several years of its ownership. These excess losses can be applied to the investor's income from sources other

than real estate which reduces the investor's taxable income. If an investor is in the highest tax bracket of 50 percent, each one dollar of depreciation reduces the investor's tax bill by 50 cents. This makes the potential return on investment in real estate a function of its cash flows during operation along with the eventual gain on sale of the property plus the present value of the stream of depreciation losses discounted by the investor's marginal tax rate. Thus, investors in real estate are interested not only in the possible increase in the value of the property over time but in the tax reducing value of the excess depreciation that the investment provides over and above any gain on sale. As other forms of investment did not enjoy such tax treatment, real estate has held a competitive advantage and attracted capital to it that might otherwise have been invested in other sectors of the economy.

For example, assume a residential rental property is purchased for $1,000,000 of which $800,000 is the non-land depreciable basis. Assume also that the project's deductible operating expenses and interest payments equal its collected rental income. As the property's taxable income is zero, the depreciation deductions have no value in terms of reducing any tax liability from the property itself. However, the depreciation can be used to reduce tax liability on income from sources other than the property, such as the salary income of the owner. The depreciation deductions allowable on the $800,000 would be 10 percent, or

$80,000, in the first year. These deduction could be used by the property owner as a deduction against income from sources other than the rental property. Assuming that the owner is in the 50 percent tax bracket, these deductions are worth $80,000 x .50 = $40,000. The owner may not need all of the these losses generated by the property and may elect to syndicate the property. Syndication is the process of allowing additional investors to join in the ownership of the property. These investors pay to the developer an amount based upon the value of the tax losses that the investor can obtain from the property. If an investor is in the 50 percent tax bracket and applies a 30 percent risk factor to the property, then the depreciation deductions would be worth $80,000 x .50 x (1-.3) = $28,000. Thus the investor would pay the developer $28,000 for the $80,000 worth of deductions generated by the development during its first year of operation.

Capital gains exclusion income. Income derived from the sale of a piece of real estate has been taxed at a lower effective tax rate than has been true for ordinary income due to the provisions of the income tax code that exclude from taxation a fixed percentage of capital gains income. When a property is sold its price is determined by its initial cost plus its appreciation in value. With inflation, the sale price is generally greater than the original purchase, making the gain on sale the difference

between the purchase price and the sale price net of sale costs. While the appreciation in the property's value occurs over time, the realization of this gain all occurs in one year, at the time of sale. This boosts the income of the ownership in the year of sale which can raise the owner to higher tax brackets. In addition to this problem of crowding all of the gain into a single year, some of the gain may represent increases in the selling price of the property due to inflation. The price of the property at the time of sale may be greater than the original purchase price, but this may be due to general increases in prices and not due to real appreciation in the property's value over and above inflation. To tax all of this gain is to tax inflationary increases rather than real increases in value.

For these reasons, crowding of income and the effects of inflation, income from the capital gains has been taxed differently than ordinary income. The first 60 percent of income from a capital gain is exempt from taxation. This means that the effective tax rate on capital gains has been only 40 percent of the investor's marginal tax rate. For an investor in the highest tax bracket of 50 percent, income from capital gains has been taxed at 20 percent. This created an incentive to find a form of investment that generates capital gains rather than gains taxed at ordinary tax rates. Income from the sale of real estate had this further advantage over ordinary income attracting capital to this sector of the economy.

Rehabilitation tax credits. The tax codes have been used to give additional incentives to special types of real estate, such as buildings registered as historic places. A tax credit is a tax reduction with each dollar of tax credit reducing the investor's tax bill by one full dollar during the year in which the tax credit is taken. A credit is different from a deduction in that a deduction reduces the taxable income amount for each year that the deduction is allowed but is valued only at the marginal tax rate. A credit reduces the investor's tax bill by the full amount of the credit.

Tax credits have been allowed for certain types of investment deemed to serve a public purpose. The rehabilitation of historic buildings is viewed as serving a public goal, and, therefore, merits use of a one time credit calculated as a fixed percentage of the rehabilitation costs. Under current tax law the credit is calculated as 25 percent of rehabilitation costs.

Tax credits for rehabilitation have many conditions that must be satisfied in order to make use of them. If the investor chooses to take the tax credit, then the rehabilitation costs must be depreciated using a straight line method. Further, the depreciation is not allowed on the entire amount of the rehabilitation costs; the investor may depreciate only the rehabilitation costs minus 50 percent of the amount of the tax credit.

Even with these limitations, tax credits have provided a substantial incentive for investment in properties suitable for rehabilitation. While use of straight line depreciation on a reduced depreciable basis has less value than the use of accelerated depreciation, the present value of the tax credit plus the value of the straight line depreciation deductions will, in general, far exceed the present value of deductions using accelerated depreciation. This excess value provides a strong financial incentive toward investment in property that qualifies for the historic rehabilitation tax credit as opposed to property developed through new construction.

All four of these tax provisions - accelerated depreciation, sheltering non-real estate income through real estate losses, capital gains tax rates and tax credits - have all attracted capital to real estate. Many properties that are losing money in terms of their before tax cash flows actually are worthwhile investments because of these tax benefits which can, and often do, change a before tax loss into a healthy after tax profit. This process has kept many housing developments viable that would not have been possible without these tax preferences. This is especially true for many subsidized housing developments designed for low- and moderate-income households. Virtually all multi-family rental housing built during the last 10 years was "tax leveraged" to some extent because the value of these tax benefits was made a part of the development

process. This process has been crucial to the growth of Boston's housing stock because of Boston's dependence upon multi-family rental developments to provide the needed additions to the stock.

<u>Revisions to the Tax Code.</u>

The federal government has revised a broad range of income tax laws and a lengthy list of revisions have been written covering many aspects of the taxation process. Several of these proposals effect real estate. Clearly the net result of these changes will be to reduce the tax preferences that have been given to real estate in the past. This will reduce the incentives for investment in real estate making it compete on more equal terms with other sectors of the economy for investment capital. This will result in either a lower return on investment in real estate developed under the new tax laws compared to that developed under the old laws or will mean that higher rents will have to be charged in order to obtain the same return on investment because of the reduction in the value of the tax benefits.

The changes found in the tax reform bill cover a wide range of issues, but five are the most important to investment in rental housing. These are changes in the four aspects of taxation discussed above - accelerated depreciation, income sheltering, capital gains taxation and

tax credits - plus the added changes to the tax rates themselves.

Revision of marginal tax rates. Prior to tax reform the highest tax rate has been 50 percent. Under the tax reform bill only two rates will exist, 15 and 28 percent plus a surcharge. The 15 percent rate applies to income up to about $30,000 for households filing joint returns. The 28 percent rate is applied to income above that level. However, the savings of the 15 percent rate is phased out for income between $72,000 and $150,000 through a surcharge which raises the marginal rate to about 33 percent. This surcharge brings the taxpayer up to a 28 percent tax rate on all income including the amount normally taxed at 15 percent. This means that such deductions as depreciation that would have been valued at 50 cents per dollar of deduction will be valued, in general, at 28 cents per dollar although some households will confront the surcharge as well. This will reduce the overall value of the tax losses generated by real estate. In addition, the reduced top level of taxation may reduce the need among some taxpayers for tax shelters as the level of taxation on any income will be reduced.

Revision of capital gains exclusion. The previous tax law excluded the first 60 percent of capital gains income from taxation. This makes the maximum capital gains tax rate 20

percent calculated as the taxable portion of capital gains times the highest marginal tax rate or (1 - .6)x(.5). Tax reform eliminates the capital gains exclusion by taxing capital gains in the same manner as ordinary income to a maximum of 28 percent. Clearly, this eliminates the relative advantage that real estate enjoyed due to the preferential treatment granted to this type of income.

Revision of rehabilitation tax credits. Prior to tax reform, the rehabilitation of residential rental property listed on the national register of historic buildings earned a one time tax credit of 25 percent of the rehabilitation costs. The depreciable costs of the rehabilitation were the full rehabilitation costs minus 50 percent of the tax credit and the straight line method had to be used. Several other requirements had to be met in terms of preservation of the building's structure and exterior walls.

Under tax reform, the historic tax credit has been reduced to 20 percent, and the full amount of the tax credit must be deducted from the rehabilitation costs prior to the calculation of depreciation.

Revision of depreciation deductions. The tax law prior to tax reform used the Accelerated Cost Recovery System (ACRS) for the calculation of accelerated depreciation deductions. The government provided a set of tables for calculation of the allowable deduction in lieu of using complex formulas.

For rental housing, the ACRS deductions closely approximate the depreciation that would be obtained as if a 19 year depreciable life had been assumed and a 175 percent acceleration rate had been used for the calculations. This has been the depreciation system allowed for most real estate except subsidized housing which has been permitted to use 15 years and 200 percent accelerated depreciation (referred to as the double declining balance system).

Tax reform eliminates the ACRS while attempting to retain some benefits for housing marketed to low- and moderate-income households. With tax reform, all housing must be depreciated using a straight line method and a 27.5 year depreciable life. Non-housing properties must use a 31.5 year life. Rather than modify the depreciation schedules for housing marketed to low- and moderate-income households, tax reform has opted for use of tax credits.

The credits can be claimed each year for a period of ten years during which time the housing must be occupied by households with incomes that meet certain limitations. These limitations are that at least 20 percent of the housing units in the development be occupied by households with income of 50 percent or less of the area median or at least 40 percent of the housing units be occupied by households of 60 percent or less of the area median. The credit is 9 percent of new construction or rehabilitation costs. An additional credit of 4 percent for acquisition costs of existing property is also allowed. If a low-income

occupancy credit is taken on rehabilitated property, then the rehabilitation costs must be greater than $2,000 per unit. These credits do not reduce the depreciable basis of the property but can be taken against rehabilitation costs of historic property only after reduction of the basis by the amount of the historic rehabilitation credit.

The income limits are to be adjusted for family size and the rent charged may not exceed 30 percent of the qualifying (not the tenant's) income. In addition, if the credits are claimed, the development must meet the low-income occupancy requirements for 15 years which is longer than the 10 year period over which the credits are claimed. Recapture of credits occurs if the development does not comply. Further, there will be a limit on the dollar value of credits claimed in each state set at $1.25 per resident. These credits must be allocated over all eligible developments by the state government.

<u>Extension of the "at risk" rules to real estate and limitations on the use of passive losses.</u> Under the tax laws prior to tax reform, losses from real estate could be deducted from an investor's income even if the losses exceeded the amount for which the investor was "at risk". Losses from non-real estate may be deducted up to a fixed cap which has been determined, generally, by the amount directly invested and the amount borrowed to purchase the investment which must be repaid if the investment fails.

Tax reform will extend the "at risk" rules to real estate, but these rules will not, by themselves, severely limit rental housing development. This is because the investor is considered to be at risk with respect to the amount of the debt on the property if borrowed from a qualified lender.

Passive loss limitations. Tax reform will severely constrain the transfer of real estate losses to offset non-real estate income such as wages. It separates income into three categories: active (wages, salaries, etc.), portfolio (dividends and interest) and passive (rental property income and income from businesses in which the investor is not actively engaged in the day-to-day management). Passive income can only offset other passive income. Losses or tax credits from real estate in which the investor is not actively engaged in the property's management cannot be used against wage, salary or dividend income. This will provide a major obstacle in the process through which investors have become members in partnerships created to own real estate which provides tax losses as a form of return on investment.

Tax reform has allowed for some exceptions on the transfer of real estate losses to income from other sources. A property owner may deduct up to $25,000 of such losses if the owner actively participates in the operation of the property. A limited partner is not considered an active participant in property management. Further, the $25,000

deduction exception is phased out on incomes from $100,000 to $150,000.

The rehabilitation tax credit and the low-income tax credits are subject to limitations in their use that are similar to the limitations imposed upon the use of depreciation deductions. An individual taxpayer is allowed to claim only the credit equivalent of $25,000 in deductions. If in the 28 percent tax bracket, this amounts to $7,000 per taxpayer, a figure so low, that it may be difficult to attract investors to a development. In addition, this credit is phased out for individual taxpayers whose income is in excess of $200,000.

The full consequences of these provisions are difficult to quantify for this type of analysis. Developers have used the syndication of tax losses and the exemption of real estate from the "at risk" rules to raise equity funds for developments. Developers sold memberships in limited partnerships, in effect, selling a property's tax losses. The sale proceeds were used to meet the equity requirements of lenders or to provide a profit which could not be generated by the rental income alone. Without the ability to sell tax losses, developers must find new sources of equity or be able to self-finance the equity. Some developers may be unable to do this.

The Impact of the Proposed Changes on Development in Boston.

The issue that arises with all of the changes is, what will be the net effect upon rental housing development in Boston? The answer is found through the preparation of sample income and expense statements for typical developments in Boston under three different sets of taxation rules - existing tax law, tax reform without syndication of tax credits and, assuming that it will be possible to sell low-income and historic rehabilitation tax credits to investors, tax reform with syndication of tax credits.

The income and expense statements have been generated for several alternative developments with each setting rents such that a 16 percent after tax internal rate of return on investment is realized on the cash flows received from the development. This 16 percent return is considered to be an accepted threshold for investment in real estate so as to cover inflation, profit requirements and the risk associated with this type of investment. A return lower than 16 percent after tax may be insufficient to attract investors to this type of investment in Boston. Recent research indicates that this is a reasonable rate of return to expect given the average after tax returns paid by a set of private syndication funds. (See Rogers and Owers, The investment performance of real estate limited partnerships. AREUA Journal, 13(2): pp. 153-166. 1985.)

The internal rate of return is that interest rate which, when used to discount all of the cash flows received during the operation of the property and to discount the proceeds from the sale of the property, equates the sum of these discounted funds to the original investment. As a measure of return on investment, internal rate of return has the advantage of providing a common measure of investment performance despite unequal flows of income. In this analysis the internal rate of return is calculated on after tax cash flow and sale proceeds so as to capture the effects of the tax laws upon the investment. By making all alternative developments analyzed achieve the same IRR, each can be considered to be comparable investments despite different amounts and timing of income flows.

An alternate approach to this method is to hold rents constant, presumably at market levels, and to determine the different levels of return on investment that can be obtained from investment in rental properties under each tax scenario. This has not been done here on the assumption that investors demand a minimum or threshold return in order to invest in rental properties and that investment properties developed under the new tax laws will be located in those market areas able to sustain the rents necessary to provide the expected return on investment.

Preparation of typical income and expense statements requires that a great many assumptions be made with regard to the costs of developing and operating rental housing in

Boston. The level of the rents found through such analysis is sensitive to these assumptions. However, what is important is not so much the absolute level of rents determined under either tax system but the differences between the rents under tax law before tax reform versus rents after tax reform. Tests of different assumptions on development costs and operating expenses indicate that the differences in rents due to changes in the tax code can be significant. The set of assumptions used here are conservative in that they demonstrate relatively moderate increases in threshold rents in order to provide a constant return on investment with tax reform. Many other, equally reasonable, sets of assumptions concerning development costs and operating expenses demonstrate that the increases in rents that may result from tax reform could be much greater than those illustrated in this report.

The assumptions cover the costs of building, developing, financing and operating rental housing in Boston. Data for these assumptions have been taken from a variety of Boston area sources both public and private, so as to reflect the costs of rental housing development in Boston proper. These assumptions are summarized as follows:

1. Total development size of 100 apartments of 1,000 square feet each,

2. Total development costs of $70 per square foot for a total of $7,000,000 which, for the rehabilitation

jobs, is assumed to break down into $2,000,000 for acquisition and $3,600,000 for rehabilitation,

3. Financing with an 80 percent loan at 11 percent interest for a term of 30 years,

4. Operating expenses of approximately $3,400 per unit which includes all utilities with these costs rising 5 percent per year except for property taxes which rise at 2.5 percent per year,

5. Rents going up 4 percent per year,

6. Property values increasing at the same rate as income 4 percent per year,

7. The property will be held for 15 years and then sold with selling costs being 4 percent of the sale price,

8. The investor is assumed to be at the highest marginal tax rate and requires a 16 percent after tax return on investment.

9. For those alternatives where syndication is assumed to be possible, the investor pays 70 percent of the tax reducing value of the credits purchased,

10. Median area income of about $24,000. If a household is to spend 30 percent of income on housing, a household at 60 percent of median income should have a rent no more than $360 per month and a household at 50 percent of the median should have a maximum rent of $300.

Required rents from alternative income and expense statements.

Break-even rent analysis for a 16 percent after tax return has been performed for two separate development types, first, a new construction development and, second, rehabilitation of a historic building. For each of these development alternatives, three schemes of unit allocation for low- and moderate-income households have been tested. First, developments with no units set aside are analyzed under both current tax law and tax reform. Second, under tax reform two alternatives are studied: a.) 20 units set aside at $300 rent and b.) 40 units set aside at $360 rent. These allocations qualify the development for the special tax credits.

The initial rents that are required for the market rate units in each of these alternative development types are listed in Table 1. It is assumed that all rents increase at a constant rate with time. This means that higher rents are not only higher at the start of a development's operation, but will become even higher with time as growth based on a percentage increase is greater in absolute terms given a higher initial base. These base rents are calculated assuming that all of the properties cost the same to develop and operate, that they will all be held for 15 years and that they all must provide a 16 percent after tax internal rate of return on investment. The differences in the rents

are due, entirely, to the effects of the differences between the existing tax code and the proposed tax reform package.

Tables 2 and 3 illustrate the before and after tax reform analysis of a typical alternative.

<u>Increases in threshold market rents.</u>

A typical 100 unit new construction rental apartment development built under tax reform with no units set aside for low- or moderate income would require market rents 19 percent higher than would be required by the same development prior to tax reform. This effect is due solely to the changes in the tax benefits which severely reduces the ability of a new development to transfer excess depreciation losses along to investors.

Historic rehabilitation continues to be favored under tax reform but the value of the benefits have decreased. Prior to tax reform, a development involving historic rehabilitation was able to enter a market with rents that were 20 percent lower than was true for a development that was newly constructed. This was true due to the value of the rehabilitation tax credit. Under tax reform, if investors can be found who will purchase the losses available through the rehabilitation tax credit then the value of rehabilitation credits translates into a 5 percent reduction in the market rents. Without the ability to sell these credits to investors, then the development is unable

to benefit from the credit fully. As a result the market rents will be reduced by a negligible 1 percent.

Under tax law prior to tax reform, no special credits are given for units set aside for low- or moderate-income households. To maintain a constant return on investment, internal skewing of rents is required. Higher rents must be achieved in the market units in order to compensate for the reduced income earned from the units set aside at below market rates. If the mix of units is 80 market units and 20 low-income units, market rents would have to increase by 13 to 15 percent. If the mix of units is 60 market units and 40 moderate-income units, market rents would have to increase by 27 to 55 percent.

The credits granted for setting aside units for low- and moderate-income households are designed to compensate a development for the income loss associated with setting aside units. These credits have a value if they can be syndicated. The value of these credits, however, does not appear to fully compensate a development for the income lost by offering units at below market rents. In all cases, the market rents in developments need to be higher to achieve the same return with set aside units than would be the case without set aside units.

For a typical new construction development with an 80/20 mix of units, the market rents would have to increase by 12 percent even if the credits can be syndicated. However, the increase in market rents would have to be 17

percent if the credits could not be syndicated. For a development with a 60/40 mix of units, the market rents would have to increase by 17 percent if the credits could be syndicated. The increase, without syndication, would be 39 percent. Thus, the credits do have value if syndicated, and this value does provide some partial relief for the reduced income with below market units. But the credits do not go far enough in rewarding a developer for setting aside the units as there is a net income loss.

Conclusion.

Tax reform will reduce the preferential treatment granted to real estate. In order for rental housing developments to provide the same rate of return on investment, developments must locate in market areas able to sustain higher rents than has been required under current tax law. The increases found in testing typical Boston developments are around 19 percent with new construction to about 20 percent for rehabilitation projects. The actual difference will, of course, vary as a function of the cost constraints that actual developments confront. However, these increases provide a reasonable estimate of the impact of tax reform upon new rental developments in Boston.

Tax reform has gone some distance to direct tax benefits toward those properties which set aside units for low- and moderate-income households. The developments get tax credits if sufficient units are set aside, but these

benefits do not appear to equal the costs of setting aside these units. Therefore, there is no reason for a developer to choose this option without some other external requirement or additional benefits provided.

The tax reform package continues the policy of favoring rehabilitation projects. This type of development can operate at lower rents than new construction developments, all other things being equal. The degree of difference between new construction and rehabilitation has, however, been narrowed with tax reform.

The effects of these changes are generally negative for Boston. Multi-family rental housing becomes a less attractive form of investment with tax reform reducing the incentives for developers to undertake projects. Projects that may have been marginal in the past under the old tax laws may no longer be viable under tax reform. This will cause developers to seek out only relatively strong market areas for developments, markets where the rents are sufficiently high to sustain the project's required income. They will avoid markets where the rents are at lower levels despite what may be a pressing need for housing. While this has always been true in real estate development, it becomes more so with tax reform.

This will be a problem for Boston as it continues to attempt to attract developers to the "moderate" rental markets as opposed to the "hot" markets where high rents are standard. The costs involved in setting aside these units

will have to be absorbed through some combination of methods. First, if the city requires that units must be set aside, then the costs must be carried by the developer through lower returns on investment. Second, lower prices will be paid for developable parcels of land as the reduced value of a development is capitalized through to lower land prices. Third, the city can attempt to absorb some of the costs through forms of direct and in-kind subsidies such as land write-downs, reduced taxes or lower fees.

Table 1 Initial Rents per Month on Market Units
Boston Multi-family Rental Development

	New Construction			Rehabilitation		
Market Units	100	80	60	100	80	60
Low-Income Units	0	20	0	0	20	0
Mod-Income Units	0	0	40	0	0	40
Pre-Tax Reform:	765	881	1035	612	690	780
Tax Reform:						
No Syndication:						
No Credits	909	1061	1275	909	1061	1275
Rehab Credits	-	-	-	899	1049	1259
Set Aside Units	-	1051	1261	-	-	-
Rehab & Set Aside	-	-	-	-	1049	1259
With Syndication:						
Rehab Credits	-	-	-	863	1004	1198
Set Aside Units	-	1016	1057	-	-	-
Rehab & Set Aside	-	-	-	-	975	1121

Source: Boston Redevelopment Authority, Research Department.

REAL ESTATE INVESTMENT ANALYSIS PROJECT ANALYSIS SECTION	TABLE 2 100 MARKET RATES UNITS NEW CONSTRUCTION NO UNITS SET ASIDE FOR LOW-INCOME TAX REFORM 15 YEAR PROFORMA	BRA RESEARCH

OPERATIONS YEAR	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
GROSS INCOME RESIDENTIAL	1090800	1134432	1179809	1227002	1276082	1327125	1380210	1435418	1492835	1552549	1614650	1679236	1746406	1816262	1888913
VACANCY RESIDENTIAL	54540	56722	58990	61350	63804	66356	69010	71771	74642	77627	80733	83962	87320	90813	94446
EFFECTIVE GROSS INCOME	1036260	1077710	1120819	1165652	1212278	1260769	1311199	1363647	1418193	1474921	1533918	1595275	1659086	1725449	1794467
OPERATING EXPENSES	360375	376472	393326	410973	429452	448803	469069	490293	512523	535808	560198	585748	612514	640555	669933
DEBT SERVICE	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961
BEFORE TAX CASH FLOW	35924	61277	87532	114718	142865	172005	202170	233393	265709	299152	333758	369565	406611	444933	484573
INTEREST EXPENSES CLAIMED	614754	611837	608583	604952	600901	596380	591337	585711	579433	572428	564614	555895	546166	535313	523203
DEPRECIATION CLAIMED	61131	89401	118910	149727	181925	215585	250794	287644	326237	355009	203636	203636	203636	203636	203636
TAXABLE INCOME	0	0	0	0	0	0	0	0	0	11676	205470	249996	296769	345946	397695
TAX ON OPERATIONS	0	0	0	0	0	0	0	0	0	3269	57532	69999	83095	96865	111355
TOTAL SYNDICATION VALUE	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
AFTER TAX CASH FLOW OPTNS	35924	61277	87532	114718	142865	172005	202170	233393	265709	295883	276227	299567	323515	348068	373218
REVERSION															
SALE PRICE	7280000	7571200	7874048	8189010	8516570	8857233	9211522	9579983	9963183	10361710	10776178	11207226	11655515	12121735	12606605
SALE COSTS															504264
MORTGAGE BALANCE	5574793	5546669	5515290	5480281	5441220	5397639	5349015	5294765	5234236	5166703	5091355	5007289	4913494	4808845	4692086
BEFORE TAX CASH FLOW															7410254
CAPITAL GAINS															8156886
DEPREC SUBJ TO RECAPTURE															0
TAX CAPITAL GAINS															2283928
TAX ON DEPREC RECAPTURE															0
RECAPTURE OF ITC															0
AFTER TAX CASH FLOW REV															5126326
IRR AFTER TAX															16.02

REAL ESTATE INVESTMENT ANALYSIS
PROJECT
ANALYSIS SECTION

TABLE 3
100 MARKET RATE UNITS NEW CONSTRUCTION NO SET ASIDE FOR LOW-INCOME
TAX CODE PRIOR TO TAX REFORM PROFROMA

BRA
RESEARCH

OPERATIONS YEAR	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
GROSS INCOME RESIDENTIAL	918000	954720	992909	1032625	1073930	1116887	1161563	1208025	1256346	1306600	1358864	1413219	1469748	1528537	1589679
VACANCY RESIDENTIAL	45900	47736	49645	51631	53697	55844	58078	60401	62817	65330	67943	70661	73487	76427	79484
EFFECTIVE GROSS INCOME	872100	906984	943263	980994	1020234	1061043	1103485	1147624	1193529	1241270	1290921	1342558	1396260	1452111	1510195
OPERATING EXPENSES	360375	376472	393326	410973	429452	448803	469069	490293	512523	535808	560198	585748	612514	640555	669933
DEBT SERVICE	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961	639961
BEFORE TAX CASH FLOW	-128236	-109449	-90024	-69940	-49179	-27721	-5545	17370	41044	65501	90762	116849	143785	171595	200301
INTEREST EXPENSES	614754	611837	608583	604952	600901	596380	591337	585711	579433	572428	564614	555895	546166	535313	523203
TOTAL DEPRECIATION	515789	468283	425151	385993	350441	318163	294737	294737	294737	294737	294737	294737	294737	294737	294737
TAXABLE INCOME	-618819	-549608	-483796	-420923	-360559	-302303	-251658	-223117	-193164	-161703	-128628	-93821	-57157	-18493	22322
TAX ON OPERATIONS	-309409	-274804	-241898	-210462	-180280	-151152	-125829	-111558	-96582	-80851	-64314	-46911	-28578	-9247	11161
TOTAL TAX CREDITS	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
AFTER TAX CASH FLOW OPTNS	181173	165355	151875	140521	131100	123431	120284	128928	137626	146353	155075	163759	172364	180841	189139
REVERSION															
SALE PRICE	7280000	7571200	7874048	8189010	8516570	8857233	9211522	9579983	9963183	10361710	10776178	11207226	11655515	12121735	12606605
SALE COSTS															504264
MORTGAGE BALANCE	5574793	5546669	5515290	5480281	5441220	5397639	5349015	5294765	5234236	5166703	5091355	5007289	4913494	4808845	4692086
BEFORE TAX CASH FLOW															7410254
CAPITAL GAINS															9523393
DEPREC SUBJ TO RECAPTURE															695399
TAX CAPITAL GAINS															1904679
TAX ON DEPREC RECAPTURE															347699
RECAPTURE OF ITC															0
AFTER TAX CASH FLOW REV															5157876
IRR AFTER TAX															16.01

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BPL Form No. 1236—9/67

The Boston Housing Authority was established in 1935 to take advantage of federal aid in the construction of low-rent public housing. Currently, the Authority operates 69* developments in Boston, with a total of 15,425 housing units. Out of that total, 12,967 are currently occupied and 2,458 are vacant and/or boarded up; 11,369 are designated family units and 4,058 are elderly. Within many of the elderly housing developments, units are specified for physically disable persons. Ten percent of Boston's population or close to 56,000 people live in housing that the Housing Authority either owns or oversees. In order to be eligible for admission to BHA developments, a family's income must fall below certain federally or locally set maximums. At the present time, income units range from up to $18,100 for a family of one to up to $32,300 for a family of eight.

Housing developments in Boston are located in every neighborhood with the exception of Back Bay, Beacon Hill and Downtown. The majority of family units are concentrated in Jamaica Plain/Mission Hill and South Boston. The majority of elderly units are concentrated in Dorchester and the South End.

The mean year of initial occupancy for all the developments is 1964. The first development to be occupied was the Mary E. McCormack in South Boston in 1938, and the last new construction occurred in 1982. Ten developments out of the total 69 are either currently undergoing renovation or will be over the next five years. Due to the uncertainty of the federal financing scheme it is possible that additional units

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* When counting Rutland, E. Springfield and Franklin Field Elderly as separate developments.

will receive renovations by 1990, or that currently scheduled plans will be postponed.

Both the federal and state governments are involved in the financing of BHA developments. The federal government is responsible for 81 percent of all Boston developments and the Commonwealth for the remaining 19 percent. In each development, the government involved is responsible for assuming costs relating to building construction and development, as well as for paying off the principal and interest on the buildings over a predetermined period of time, usually many years. Operating expenditures including purchasing, personnel and maintenance costs, are paid by the Authority out of a combination of income from tenant rents and federal or state operating subsidy funds. Renovations are paid for out of a combination of the above monies, and by grants received from the government involved.

In 1982 a major redevelopment effort involving $82 million in federal and state funds was initiated in three state family units, Broadway, Commonwealth and Franklin Field. Renovations continue at present, with anticipated completion dates of 1985 and 1986. In addition, in 1980-81, HUD obligated approximately $25 million in conventional modernization funds to the BHA. These funds have been used for physical improvements and renovations throughout the 69 developments, including a $6.7 million appropriation specifically designated for apartment renovation work.

The Boston House Authority was ordered into receivership in 1980 by Massachusetts Superior Court Judge Paul G. Garrity. This action followed an extended tenant-initiated class action litigation in which tenants complained of poor repairs and poor management. The BHA is the

only housing authority in the country ever to be placed into receivership. As a result, renovation, rehabilitation, and increased safety became primary goals in the period 1980-1984. A two-year stabilization program, aimed at improving security and physical conditions through repair and the securing of vacant lots was also undertaken in 1980. In addition, the Authority used $2.2 million of CDBG funds in 1981-82 to initiate a Public Safety Program aimed at reducing crime and improving resident safety in the developments. The Boston Police Department created a Special Housing Unit to work in conjunction with this program.

In the fall of 1984, Judge Garrity returned responsibility for the BHA to the city because of "the confidence I feel in the Flynn Administration." Mayor Flynn appointed Doris Bunte, then a State representative from Roxbury, to serve as Administrator of the BHA. A new nine-member board has been created with public housing tenants filling five of the nine seats.

BOSTON HOUSING AUTHORITY
SUMMARY TABLE

	Total Boston	East Boston	Charlestown	South Boston	North End/ Waterfront	Back Bay/ Beacon Hill	South End
Total # Family Units by Neighborhood	11,369	771	1,120	2,545	0	0	653
% of Family Units by Neighborhood	74%	80%	92%	91%	0	0	55%
Total # Elderly Units by Neighborhood	4,058	181	96	248	100	134	540
% of Elderly Units by Neighborhood	26%	20%	8%	9%	100%	100%	45%
Total # of Units by Neighborhood	15,427	952	1,216	2,793	100	134	1,193
% of City Total		6%	8%	18%	1%	1%	8%
% Federal	81%	67%	100%	67%	100%	100%	100%
% State	19%	33%	0	33%	0	0	0
Mean Year of Initial Occupancy	1964	1956	1941	1956	1977	1973	1971
# of Occupied Units	12,967	890	965	2,654	100	130	998
% of City Total		7%	7%	20%	1%	1%	8%
% Occupied	84%	92%	79%	95%	100%	97%	84%
# of Vacant and/or Boarded-Up Units	2,458	62	251	139	0	4	195
% of City Total		3%	10%	6%	0	.2%	8%
% Vacant	16%	8%	21%	5%	0	3%	16%
Total # of Developments	69	3	2	6	1	1	8
% of City Total		4%	3%	9%	1%	1%	12%
# With Rehab Plans	14 (20%)	1 (Orient Heights)	1 (Charlestown)	1 (Broadway (D Street))	0	0	1 (Cathedral)

BOSTON HOUSING AUTHORITY
SUMMARY TABLE

	Brighton	Jam. Pl./ Mission Hill	Roxbury	Dorchester	Mattapan	Roslindale	West Roxbury	Hyde Park
Total # Family Units by Neighborhood	535	2,651	1,382	996	0	514	0	202
% of Family Units by Neighborhood	52%	89%	79%	52%	0	75%	0	44%
Total # Elderly Units by Neighborhood	486	341	358	914	64	167	176	253
% of Elderly Units by Neighborhood	48%	11%	21%	48%	100%	25%	100%	56%
Total # of Units by Neighborhood	1,021	2,990	1,740	1,910	64	681	176	455
% of City Total	7%	19%	11%	12%	.5%	4%	1%	3%
% Federal	60%	88%	90%	79%	100%	67%	100%	50%
% State	40%	12%	10%	21%	0	33%	0	50%
Mean Year of Initial Occupancy	1962	1955	1961	1974	1972	1960	1975	1970
# of Occupied Units	811	1,771	1,607	1,728	64	632	176	441
% of City Total	6%	14%	12%	13%	.5%	5%	1%	3%
% Occupied	79%	59%	92%	90%	100%	93%	100%	97%
# of Vacant and/or Boarded-Up Units	210	1,219	133	182	0	49	0	14
% of City Total	9%	50%	5%	7%	0	2%	0	.5%
% Vacant	21%	41%	8%	10%	0	7%	0	3%
Total # of Developments	5	8	10	14	1	3	2	4
% of City Total	7%	12%	15%	20%	1%	4%	3%	6%
# With Rehab Plans	1 (Fidelis Way)	5 (Heath St., Mission Hill)	1 (Orchard Park)	2 (Franklin Hill, Franklin Field)	0	1 (Archdale)	0	0

BOSTON HOUSING AUTHORITY
PUBLIC HOUSING DEVELOPMENTS
June 1985

Development	Neighborhood	Number of Family Units	Number of Elderly Units	Financing Scheme	Year Initially Occupied	Number of Occupied Units	Number of Vacant Units	Comments
Maverick	East Boston	414	0	Federal	1942	414	0	No renovation planned
Orient Heights	East Boston	354	0	State	1952	275	62	Renov. of vacant units planned
Heritage	East Boston	20	181	Federal	1975	201	0	No renovation planned
Charlestown	Charlestown	1,120	0	Federal	1940	869	251	Ongoing renovation of 177 units
General Warren	Charlestown	0	96	Federal	1972	96	0	No renovation planned
Mary E. McCormack	South Boston	1,015	0	Federal	1938	1,015	0	No renovation planned
Old Colony	South Boston	854	0	Federal	1940	854	0	No renovation planned
Broadway (D Street)	South Boston	676	0	State	1949	536	139	Ongoing renov. of vacant units
Bayview (Foley)	South Boston	0	96	Federal	1963	96	0	No renovation planned
West 9th Street	South Boston	0	84	Federal	1968	84	0	No renovation planned
Peninsula Apts (Msgr. Powers)	South Boston	0	68	State	1978	68	0	No renovation planned
Ansonia Apts.	No. End/Waterfront	0	100	Federal	1977	100	0	No renovation planned
St. Botolph St.	South End	0	134	Federal	1973	130	4	No renovation planned
Cathedral	South End	503	0	Federal	1951	340	163	Partial turnkey renov. proposed
Castle Square	South End	0	102	Federal	1968	102	0	No renovation planned
Frederick Douglas	South End	0	78	Federal	1973	71	7	No renovation planned
Washington Manor	South End	0	78	Federal	1973	72	6	No renovation planned
Hampton House	South End	0	78	Federal	1973	70	8	No renovation planned
Torre Unidad	South End	0	204	Federal	1974	198	6	No renovation planned
W. Newton Street	South End	136	0	Federal	1973			
Rutland-E. Springfield	South End	14	0	Federal	1982	145	5	No renovation planned
Commonwealth-Fidelis Way	Brighton	277	115	State	1951	189	203	Ongoing renovation of vacant elderly and family units
Faneuil	Brighton	258	0	State	1950	258	0	No renovation planned
Washington St.	Brighton	0	82	Federal	1963	75	7	No renovation planned
J.J. Carroll(Chestnut)	Brighton	0	64	Federal	1966	64	0	No renovation planned
P.H. White (Corey Rd.)	Brighton	0	225	Federal	1978	225	0	No renovation planned

Development	Neighborhood	Number of Family Units	Number of Elderly Units	Financing Scheme	Year Initially Occupied	Number of Occupied Units	Number of Vacant Units	Comments
Heath Street	Jamaica Plain			Federal	1942			
Bromley Heath	Jamaica Plain	1,020	64	Federal	1954	624	460	Ongoing partial turnkey renov.
Bickford Street	Jamaica Plain			Federal	1962			
Jamaica Pond	Jamaica Plain	0	44	Federal	1962	44	0	No renovation planned
South Street	Jamaica Plain	132	0	State	1953	132	0	No renovation planned
Armory Street	Jamaica Plain	0	233	Federal	1973	213	20	No renovation planned
Mission Hill	J.P./Mission Hill	917	0	Federal	1940	471	446	Scattered site renovations
Mission Hill Ext.	J.P./Mission Hill	580	0	Federal	1952	287	293	Partial turnkey renovation
Orchard Park	Roxbury	727	0	Federal	1942	617	110	Ongoing renovation-completed 1985-total units will be 719
Whittier St.	Roxbury	199	0	Federal	1953	197	2	No renovation planned
Lenox St.	Roxbury	304	0	Federal	1940	300	4	No renovation planned
Camden St.	Roxbury	72	0	State	1949	72	0	No renovation planned
Infill	Roxbury	26	0	Federal	1971	26	0	No renovation planned
Infill	Roxbury	28	0	Federal	1972	28	0	No renovation planned
Highland Park	Roxbury	26	0	Federal	1982	26	0	No renovation planned
Elm Hill (Holgate)	Rox./No. Dorchester	0	86	Federal	1962	86	0	No renovation planned
Warren Towers	Rox./No. Dorchester	0	104	Federal	1969	102	2	No renovation planned
Walnut Park	Rox./No. Dorchester	0	168	Federal	1970	153	15	No renovation planned
Columbia Point	N. Dorchester	1,504	0	Federal	1954	400	1,104	Not included in total
Annapolis	N. Dorchester	0	56	Federal	1962	53	3	No renovation planned
Peter Pasciucco Apts	N. Dorchester	0	96	Federal	1973	86	10	No renovation planned
Bellflower Dorset	N. Dorchester	0	114	Federal	1981	114	0	No renovation planned
Franklin Hill Ave.	S. Dorchester	375	0	Federal	1952	375	0	Ongoing renovation-375 units by 8/85
Ashmont	S. Dorchester	0	54	Federal	1962	54	0	No renovation planned
Melville (J.J. Meade)	S. Dorchester	0	40	Federal	1969	40	0	No renovation planned
Franklin Field	S. Dorchester	368	0	State	1954	199	169	Major renovation ongoing to be completed late 1985
Franklin Field Elderly	S. Dorchester	0	80	State	1962	80	0	
Ames St.	S. Dorchester	0	80	Federal	1963	80	0	No renovation planned
Codman	S. Dorchester	0	108	Federal	1972	108	0	No renovation planned
Evans St.	S. Dorchester	2	0	Federal	1973	2	0	No renovation planned
Lower Mills	S. Dorchester	0	183	Federal	1972	183	0	No renovation planned
Gallivan Blvd	S. Dorchester	251	0	State	1953	251	0	No renovation planned
Peabody Square	S. Dorchester	0	103	Federal	1982	103	0	No renovation planned

Development	Neighborhood	Number of Family Units	Number of Elderly Units	Financing Scheme	Year Initially Occupied	Number of Occupied Units	Number of Vacant Units	Comments
Groveland	Mattapan	0	64	Federal	1972	64	0	No renovation planned
Washington/Beech	Roslindale	226	48	Federal	1952	263	11	No renovation planned
Archdale	Roslindale	288	0	State	1951	250	38	Renovation of vacant units
Roslyn Apts. (Cliffmont)	Roslindale	0	119	Federal	1977	119	0	No renovation planned
Rockland	W. Roxbury	0	72	Federal	1972	72	0	No renovation planned
Spring Street	W. Roxbury	0	104	Federal	1977	104	0	No renovation planned
Fairmount	Hyde Park	202	0	State	1951	200	2	No renovation planned
Riverside/Davidson	Hyde Park	0	48	Federal	1972	48	0	No renovation planned
Hassan Apts	Hyde Park	0	100	Federal	1974	92	8	No renovation planned
Summer Street	Hyde Park	0	105	State	1981	101	4	No renovation planned

Source: Boston Housing Authority Planning Department. Prepared by Jane A. Van Buren, BRA Research Department, May 1985.